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In the Supreme Court

OF THE

United States

October Term, 1949

No. 305

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

JOHN BROWNE COMPANY,
Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR CERTIORARI.

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Table of Contents

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statement of the case	2
Argument	3
A. The decision below is clearly correct	4
B. The regulation itself, as the Commissioner once recognized, requires the result below	5
C. There is no conflict with the decisions of this Court; on the contrary, those decisions require the result below	8
D. The circuit courts are not in conflict on the instant question, but are unanimous against the petitioner	10
E. The decision below does not raise a question of any importance in the administration of the revenue	16
Conclusion	17

Table of Authorities Cited

Pages

Breuner, John, Co. v. Commissioner of Internal Revenue, 179 F.2d 685 ..... 5, 9

Busch's Kredit Jewelry Co. v. Commissioner of Int. Rev., 179 F.2d 298 ..... 3, 5, 6, 8, 9, 10, 11, 12

Commissioner v. South Texas Co., 333 U.S. 496 ... 4, 7, 8, 10, 13, 14

Commissioner of Internal Revenue v. Hecht Co., 163 F.2d 194 10

Commissioner of Internal Revenue v. Mackin Corp., 164 F.2d 527 10

Hadley Furniture Co. v. United States, 87 F.Supp. 590 ..... 5, 7, 9, 16

Kimbrell's Home Furnish. v. Commissioner of Int. Rev., 159 F.2d 608 ..... 5, 7, 8, 9, 10, 11, 12

May, Stern & Co. v. Commissioner, 463A C.C.H. Standard Excess Profits Tax Reporter, ¶5955 11

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1949

No. 805

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

JOHN BREUNER COMPANY,
Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR CERTIORARI.

Respondent, JOHN BREUNER COMPANY, in response to the petition for a writ of certiorari to the Court of Appeals for the Ninth Circuit prays that said writ be denied.

OPINIONS BELOW.

The memorandum findings of fact and opinion of the Tax Court (R. 48) are not officially reported. The opinion of the court below is reported at 179 F. 2d 685 (R. 108).

JURISDICTION.

The petitioner invokes jurisdiction under 28 U.S.C., section 1254.

QUESTION PRESENTED.

Whether a taxpayer computing its excess profits net income on the accrual basis by reason of section 736(a) of the Internal Revenue Code shall compute its accumulated earnings and profits for excess profits tax purposes on such accrual basis or on the installment basis.

STATEMENT OF THE CASE.

Respondent has no fault to find with petitioner's statement of the facts except the last sentence thereof (p. 4)[1] which suggests only that the court below held the treasury regulation invalid. The meaning and applicability of petitioner's regulations were among the points in controversy; what the Court of Appeals for the Ninth Circuit held with respect to the regulations was:

> "If and in so far as they support respondent's contentions, the cited provisions of § 29.115-3 of Treasury Regulations 111 and §§ 35.718-2 and 35.736(a)-2 of Treasury Regulations 112 are inconsistent with § 736(a) and hence are invalid."

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[1]Government's brief.

ARGUMENT.

Petitioner urges (p. 6)[2] that this case is one of general tax importance and far-reaching administrative significance. Neither assertion is justified. The special statutory provision involved affected few taxpayers and its importance disappeared with the repeal of the wartime excess profits tax some five years ago.

The issue arose under the excess profits tax statute which by section 736(a) permitted taxpayer to compute its income for excess profits tax purposes by the use of the accrual method of accounting. The excess profits tax was imposed on the "adjusted excess-profits net income."[3] This amount, speaking generally, was computed by deducting the "excess profits credit" from the "excess profits net income."[4] A component part of the "excess profits credit" was "accumulated earnings and profits."[5] The Government contends that although the taxpayer is entitled to use the accrual method of accounting to determine its "excess profits net income," it must use the installment, or modified cash method of accounting to determine its "accumulated earnings and profits."

The court below held that since the taxpayer concededly was permitted to compute its excess profits net income on the accrual basis, the statute requires that the same method

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[2]This, and all subsequent page references are to the petition filed in *Busch's Kredit Jewelry Co. v. Commissioner of Int. Rev.*, No. 804, as the petition in this case contains no argument or reasons except by reference to that petition. The question in both cases is the same.

[3]Section 710(a)(1).

[4]Section 710(b).

[5]Section 718(4).

of accounting be used in determining taxpayer's accumulated earnings and profits for excess profits tax purposes.

A. THE DECISION BELOW IS CLEARLY CORRECT.

The decision simply requires the same method of accounting for items of deduction as is admittedly required for items of income. In fact, if the result urged by the Commissioner had been the decision of the court below, it would be in direct conflict with the statements and decision of this Court in *Commissioner v. South Texas Co.* (1948) 333 U.S. 496. In that case, the taxpayer had attempted to use the accrual method in computing its accumulated earnings and profits in arriving at its excess profits credit. This Court expressly held that since the taxpayer had *not* elected to use the accrual method in computing its excess profits income and therefore reported that income on the installment method, it must report its deductions from that income on the installment method also. This Court there said (p. 501) that the regulation there involved was

> "* * * in harmony with the long-established congressional policy that a taxpayer generally cannot compute income taxes by reporting annual income on a cash basis and deductions on an accrual basis. Such a practice has been uniformly held inadmissible because it results in a distorted picture which makes a tax return fail truly to reflect net income."

The taxpayer here elected to and did report its excess profits income on the accrual basis. It was compelled, therefore, in accordance with the express words of this

Court, to use the same accrual method in determining its accumulated earnings and profits for the purposes of the same tax. The courts of all of the circuits which have decided this precise question have so held.

Busch's Kredit Jewelry Co. v. Commissioner of Int. Rev. (2 Cir. 1950), 179 F.2d 298;

Kimbrell's Home Furnish. v. Commissioner of Int. Rev. (4 Cir. 1947), 159 F.2d 608;

John Breuner Co. v. Commissioner of Int. Rev. (9 Cir. 1950), 179 F.2d 685;

Hadley Furniture Co. v. United States (D.C. Mass. 1949), 87 F. Supp. 590.

B. THE REGULATION ITSELF, AS THE COMMISSIONER ONCE RECOGNIZED, REQUIRES THE RESULT BELOW.

The Commissioner urges that the regulations under section 736(a) of the Internal Revenue Code were issued pursuant to express statutory authority, which granted to the Commissioner a greater than ordinary power and discretion. The Commissioner concedes, however, that his regulation cannot be valid if it is unreasonable or plainly inconsistent with the statute.

Congress never granted the Commissioner any authority to require that income, for the purpose of computing the excess profits tax income, should be determined on the accrual basis and income for the purpose of computing deductions from that excess profits income in the form of the excess profits credit should be determined on the installment or modified cash basis. As Judge A. N. Hand

said in *Busch's Kredit Jewelry Co. v. Commissioner of Int. Rev.* (2 Cir. 1950), 179 F. 2d 298, 299:

> "In our opinion the method of accounting required by the Commissioner in the case at bar would be just such a 'hybrid method' of accounting as was held improper by the Supreme Court. It seems to us quite unnatural to report equity invested capital for the excess profits tax credit on a cash basis, yet this is exactly what the Commissioner holds to be necessary."

The Commissioner makes much of the argument that in providing for the election involved here section 736(a) states that it shall apply to "income." He emphasizes that section 736(a) says nothing about "earnings and profits." Furthermore the Commisisoner says (p. 16) that "the content of earnings and profits is historically a creature of Treasury Regulations." The regulation here involved provides:

> "* * * the determination of accumulated earnings and profits shall be made without regard to any adjustment resulting from election made under section 736(a) and this section, except as such election is reflected in the amount of income tax *or excess profits tax* payable for taxable years beginning after December 31, 1939" (Regs. 112 § 35.736(a)-2) (emphasis added).

The regulations in defining accumulated earnings and profits, therefore, clearly provide that such income as has

been reflected in the amount of excess profits tax payable shall be included in earnings and profits.[6]

In the Government's petition for a writ of certiorari in the *South Texas* case itself, moreover, the Government's brief (p. 13) in referring to the decision of the Court of Appeals in *Kimbrell's Home Furnish. v. Commissioner of Int. Rev.* (4 Cir. 1947), 159 F.2d 608, expressly said:

> "* * * the *Kimbrell's* case differs from the present case in a crucial respect. In the *Kimbrell's* case, the taxpayer had taken advantage of an option in Section 736(a) of the Code, whereby it accrued (for excess profits tax purposes) its gains on installment sales in the year that sales were made, and actually paid taxes with respect to such gains. Such gains were thus in fact *recognized* for excess profits tax purposes and were therefore included in the corporation's 'earnings and profits.'"

In his brief before the Court of Appeals for the Ninth Circuit in this case (p. 24), the Commissioner referred to the following words from the *Kimbrell's* case:

> "Indeed the Commissioner has recognized the reality of the accumulated profits in question by subjecting them to the additional excess profits tax which became due when the taxpayer's income in the preceding years was adjusted to an accrual basis."

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[6]Despite the clear meaning of his own regulation, the Commissioner takes the court below to task in the following words (pp. 13-14):

> "* * * the statute does not say, as the court below would in effect refashion it, that recognition in computing 'excess profits net income' is sufficient."

The Commissioner's regulation, however, seems to say that such recognition is sufficient and the Commissioner so stated in his petition to this Court in the *South Texas* case (see p. 7, *infra*). Judge Ford so held in *Hadley Furniture Co. v. United States* (D.C. Mass. 1949) 87 F. Supp. 590, *infra*, p. 15).

The Commissioner then asserted that:

> "It is not true that the Commissioner 'subjected' the installment profits to excess profits tax. On the contrary the taxpayer exercised the privilege of accruing these profits only for excess profits tax purposes to obtain a specific benefit. The taxpayer's income was otherwise not adjusted to an accrual basis."

After this express contradiction of the statement which he had made to this Court in his petition in the *South Texas* case, the Commissioner proceeds to argue that the *South Texas* case requires the disapproval of the *Kimbrell's* case.

C. THERE IS NO CONFLICT WITH THE DECISIONS OF THIS COURT; ON THE CONTRARY, THOSE DECISIONS REQUIRE THE RESULT BELOW.

Any confusion that may exist as to the meaning of the decisions of this Court is in the mind of the Commissioner. The courts have had no trouble in determining the meaning of and applying this Court's decision in the *South Texas* case. Thus, the Court of Appeals for the Second Circuit in the case of *Busch's Kredit Jewelry Co. v. Commissioner of Int. Rev.* (2 Cir. 1950), 179 F.2d 298, 299 said:

> "While the Commissioner did not seek to review the decision of the Fourth Circuit by petitioning for a writ of certiorari, he now argues that the opinion by Justice Black in Commissioner of Internal Revenue v. South Texas Lumber Co., 333 U.S. 496 [48-1 USTC ¶ 5922], * * * whereby a decision of the Fifth Circuit reported at 162 F.2d 866 [47-2 USTC ¶ 5912], was reversed, shows that the decision of the Fourth Cir-

cuit in Kimbrell's Furnishings, Inc. v. Commissioner, supra, was erroneous. We cannot regard the contention of the Commissioner as sound. * * *

In our opinion the method of accounting required by the Commissioner in the case at bar would be just such a 'hybrid method' of accounting as was held improper by the Supreme Court. It seems to us quite unnatural to report equity invested capital for the excess profits tax credit on a cash basis. Yet this is exactly what the Commissioner holds to be necessary.

The words of Mr. Justice Black, 333 U.S. at page 501, 68 S. Ct. at page 698 of his opinion in the South Texas case, to the effect that Treasury Regulations should not be overruled 'unless unreasonable and plainly inconsistent with the revenue statutes', would not seem to sustain the regulation before us. While the statement enunciates a familiar rule, we think it has no application to the case at bar for the reason that Regulation 112, § 35.736(a)-2, if applied to the facts before us would fly in the face of the natural and reasonable meaning of Section 736(a) of the Code. We agree with the result reached by the Fourth Circuit in Kimbrell's Home Furnishings, Inc. v. Commissioner, supra."

The courts have also had no trouble in understanding the holding of the *Kimbrell's* case. In fact, two other circuit courts and Judge Ford in the First Circuit have followed the *Kimbrell's* case. *Busch's Kredit Jewelry Co. v. Commissioner of Int. Rev.*, supra; *John Breuner Co. v. Commissioner of Int. Rev.* (9 Cir. 1950), 179 F.2d 685; *Hadley Furniture Co. v. United States* (D. Mass. 1949), 87 F. Supp. 590. Despite this history of litigation

and unanimity of opinion in the courts, the Commissioner persists in seeking review of these decisions. Why he does so in the *Busch's Kredit* case and in this case is impossible to understand in view of the Commissioner's statement as to the *Kimbrell's* case which he made in his petition for certiorari in the *South Texas* case. Although the Commissioner took the position that the *Kimbrell's* decision was wrong and has tenaciously maintained that position in four different circuits—the courts of which have all decided against him—at the time the *Kimbrell's* case was decided the Commissioner did not petition for certiorari.[7]

D. THE CIRCUIT COURTS ARE NOT IN CONFLICT ON THE INSTANT QUESTION, BUT ARE UNANIMOUS AGAINST THE PETITIONER.

The only conceivable reason for the Commissioner's action in pursuing the question involved in the *Kimbrell's* case through the courts of four circuits is that the Commissioner hoped to produce a conflict in decisions. He has been unsuccessful in that attempt. Three circuit courts and one district court have held that the Commissioner is

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[7]The Commissioner has, moreover, already confessed that a portion of his regulations under section 736 (a) of the Internal Revenue Code is invalid, as the courts have held (*Commissioner of Internal Revenue v. Hecht Co.* (4 Cir. 1947) 163 F.2d 194, and *Commissioner of Internal Revenue v. Mackin Corp.* (1 Cir. 1947) 164 F.2d 527) and has amended those regulations (1948-2 C.B. 2, 3, 107). The Commissioner has thus admitted that one provision of the same section of his regulations here involved was invalid. Furthermore, the regulation in the *Hecht* and *Mackin* cases was one whose meaning was clear. Here as the court below held, it is not clear that the regulations in question mean what the Commissioner says they mean.

wrong. There is therefore no reason for this Court to grant the writ of certiorari.

The petitioner urges (p. 9) that a disagreement exists between the Fourth, Second and Ninth circuits on the one hand and the Court of Appeals for the Third Circuit under the latter's recent decision in *May, Stern & Co. v. Com.* (3 Cir.), 463A C.C.H. Standard Excess Profits Tax Reporter ¶5955, decided April 10, 1950. The *May, Stern* case did not decide the question involved in this case and in the *Busch's Kredit* and *Kimbrell's* cases. In fact, the Government so states.[8] The Commissioner's implication that the *May, Stern* decision reflects a disagreement between the circuits is utterly unfounded. The court in the *May, Stern* case said, after referring to the decisions in the *Busch's Kredit* and *Kimbrell's* cases:

> "In our view, the construction of the Second and Fourth Circuits represents the limit beyond which it is impossible to go without clear conflict with the authoritative analysis made by the Supreme Court."

Furthermore, the Third Circuit said in the same opinion:

> "The elimination of such items [the uncollected profits which would be included on the accrual basis] from the credit side of the taxpayer's computation after his income has been calculated on the accrual basis may impose serious hardship."

The court in the *May, Stern* case, however, was exclusively concerned with pre-1940 accumulated earnings and profits. It held that despite the hardship which it recognized, Congress had "advertently or inadvertently" al-

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[8] p. 14.

lowed that situation to exist. The court, therefore, felt it was compelled to reach the decision it did with respect to pre-1940 accumulated earnings and profits.[9]

For the Government to assert in these circumstances that there is a disagreement between the Third Circuit and the Second, Fourth and Ninth circuits, is a patent distortion of the facts. It is clear from its opinion that, if faced with the question of post-1940[10] accumulated earnings and profits, the question which is raised by this case and the *Kimbrell's* and *Busch's Kredit* cases, the Third Circuit would reach exactly the same result as have the other circuit courts.

The petitioner endeavors (pp. 8-9) to make weight of the fact that the Tax Court of the United States "has consistently * * * refused to follow the Fourth Circuit." When the decisions of the Tax Court are examined, however, it is apparent that they can be given little, if any, weight. None of the decisions in question has been reviewed by the entire Court, and therefore cannot be taken as representing more than the opinion of the individual judges. The Tax Court judges, moreover, undoubtedly were encouraged to continue their error by the fact that the Commissioner continued to litigate the question in the other circuits after the Fourth had reversed the Tax Court decision in the *Kimbrell's* case.

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[9]The reluctance with which the court reached that result is indicated by its statement that "We are keenly aware that the result we have reached requires inconsistent accounting in the taxpayer's 1940 return."

[10]Section 736(a) explicitly distinguishes between pre-1940 and post-1940 income: "* * * the income from installment sales for each taxable year before the first year with respect to which the election is made but beginning after December 31, 1939, shall be adjusted for the purposes of this subchapter to conform to such election."

The Commissioner attempts to obscure the relatively simple issue involved in this case—at least so it has seemed to all of the courts which have decided against the Commissioner—by talking of the "general complexity of the excess profits provisions" and the "particular complexity of the instant problem" (p. 15). He also indicates that this case involves "a dual system of accounting and the interrelation of one kind of a tax based on one system of accounting to a second tax based on another system." In fact, of course, all that is involved is the excess profits tax, and whether Congress, in permitting a taxpayer to elect the accrual method to compute its taxable income under that tax allowed the Commissioner to require the taxpayer to use not the accrual method but a complex, inconsistent accounting method incorporating both the accrual and the installment methods. The provision of section 736 (a) giving the Commissioner authority to issue regulations certainly did not give him authority to require such a distorted method of accounting.

The Commissioner himself states the rule of law with respect to the deference to be accorded his regulations to be that the regulations "must control unless unreasonable and plainly inconsistent with the statute" (p. 7). The court below and all of the other circuit courts which have decided this question have held that the Commissioner's regulation as interpreted by him is plainly inconsistent with the statute. Indeed they could not do otherwise in view of this Court's decision in the *South Texas* case, for the regulation is not only inconsistent with the statute but inconsistent "with the long-established congressional policy that a taxpayer generally cannot compute income

taxes by reporting annual income on a cash basis and deductions on an accrual basis" (*Commissioner v. South Texas Co.* (1948), 333 U.S. 496, 501).

The Commissioner argues (p. 8) that section 736 (a) permitted taxpayers to report *income* on an accrual basis. He concludes, therefore, that since the section says nothing about "excess profits tax credit" or "earnings and profits", the accumulated earnings and profits here involved cannot be computed on the accrual basis. In effect, the Commissioner's argument is that section 736 (a) must be construed as though it permitted the taxpayer to compute only "excess profits net income" on the accrual basis and not the "adjusted excess profits net income", the income on which the tax is imposed.

But the statute does not say that. This section prescribes how the income to be subjected to excess profits is to be computed. It therefore follows inescapably that items both of income and of deduction which enter into the computation, must be computed by the same accounting method.

Despite the long-established principle that items of deduction must be computed under the same accounting method as items of income, the Commissioner argues that this principle is defeated by "the statutory plan of a unitary concept of earnings and profits" (p. 13). In other words, he says that although "earnings and profits" enter into the computation of "adjusted excess profits net income" as a deduction, the term must be computed under the installment method of accounting, although the accrual method is used as to all other items in the computation. The Commissioner professes to see a statutory

purpose that "earnings and profits" shall be the same amount wherever it is used in the Code; but he exposes the weakness of his own argument when he points out that some sections of the Excess Profits Tax Act expressly provide for a special computation of earnings and profits (p. 12, footnote10).[11] The Commissioner's entire argument (pp. 11-14) based upon the "unitary concept of earnings and profits" therefore collapses because of his own admission that there *is* no unitary concept of earnings and profits in the Excess Profits Tax Law. In short, the amount of earnings and profits as it enters into the computation of adjusted excess profits net income will vary according to the method of accounting used for excess profits tax purposes. The taxpayer properly elected to use the accrual method, and it flies in the face of all principles of determination of taxable income to argue, as the Commissioner does, that income is to be computed on the accrual method of accounting and deductions on the installment method. The only "unitary concept" of "earnings and profits" is that they represent such income as has been recognized for tax purposes. It appears that this income has been recognized for excess profits tax purposes, and the Commissioner has stated to this Court that this income had been recognized (p. 7 supra). Indeed Judge Ford has expressly held:

> "In the instant case, as in the Kimbrell case, the income on sales in years beginning after December 31, 1939 has been reported as taxable income for excess profits tax purposes, and is properly included in equity

[11]The Commissioner's reference to section 718 (a) (5) is obviously a typographical mistake for section 718 (c) (5).

invested capital in computing taxpayer's excess profits credit. Moreover, this seems to be the proper result under the applicable Treasury Regulation 112, Section 35.736(a)-2, which appears in part in the margin. The tax situation involved here falls within the exception provided in the regulation. Clearly, when taxpayer here changed to the accrual basis of reporting and reported as accrued taxable income the full contract price of its sales, including the amounts represented by its reserve for unrealized profits, those amounts were thereby reflected in the amount of its excess profits tax payable on the income thus reported, and were thereby reflected in the amount of its excess under § 736(a)" (*Hadley Furniture Co. v. United States* (D. Mass. 1949) 87 F. Supp. 590, 594).

E. THE DECISION BELOW DOES NOT RAISE A QUESTION OF ANY IMPORTANCE IN THE ADMINISTRATION OF THE REVENUE.

The Commissioner urges that there are approximately 100 pending cases "at various stages of the administrative and judicial process, presenting issues relating to the computation of earnings and profits, for the purposes of the excess profits tax credit, after an election under Section 736(a)" (pp. 16-17). The Commissioner, however, does not make it clear that the statute and the regulations involved are dead and of no future importance.

The number of cases pending indicates primarily that taxpayers have refused to accept the determination of the Commissioner. Certainly they are justified in their position, since all of the courts which have decided this question have held that the Commissioner is wrong. The Com-

missioner, however, says that "In view of the large number of cases extant, further litigation with a view to securing a clear-cut Court of Appeals' recognition of the Regulation's validity would at best only postpone consideration of the issue by this Court." The truth of the matter, however, is that it is now inconceivable that any conflict of decisions will arise. Three circuit courts have decided against the Commissioner, a fourth has indicated that it would follow the other three, and Judge Ford, in the First Circuit, has held that the Commissioner is wrong.

CONCLUSION.

For the foregoing reasons the petition for a writ of certiorari should be denied.

Dated, San Francisco, California,
May 17, 1950.

Respectfully submitted,
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